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LePoidevin Letter

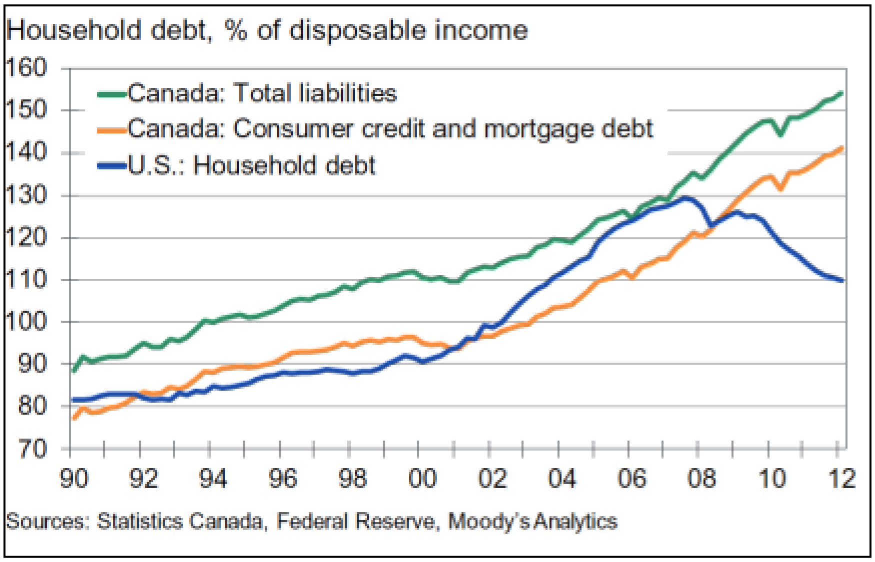
Canadian Economy Vulnerable as Lending Tightens

Economists will often refer to the economic cycle as the liquidity or credit cycle. When times are good and the economy is expanding, the ability to borrow money becomes easier; but conversely, a recession occurs when the credit cycle contracts, making borrowing increasingly difficult. Most of us can remember the recessions of 1981 and 1991, which were preceded by a sharp rise in interest rates. The high cost of borrowing dampened demand for loans, which caused an economic recession.

Despite near-record low interest rates, tight credit conditions have persisted in the U.S. since the 2008/09 recession, making the ability to get a loan difficult for many Americans.

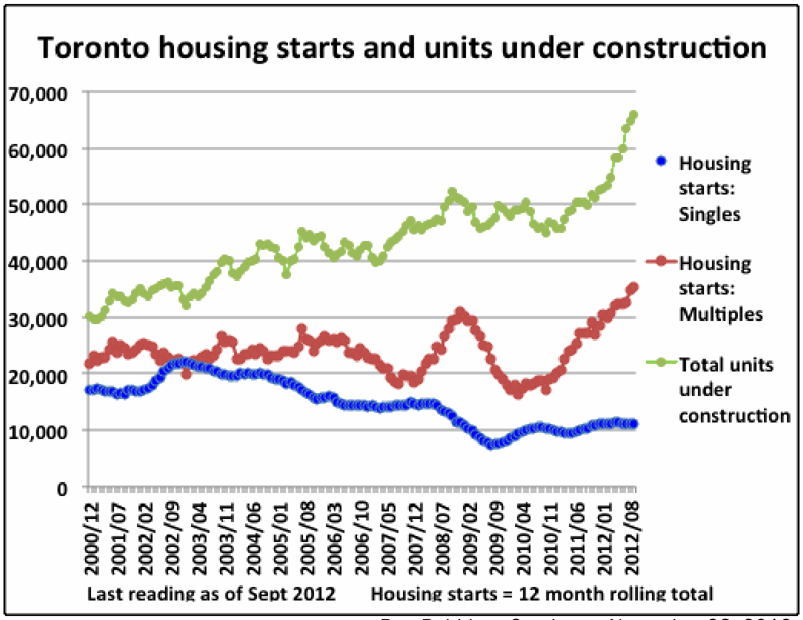
While the credit cycle affects the entire economic cycle, its effect is most apparent in housing. Where else can one borrow twenty times on their money? Think about it. Imagine walking into a bank and saying, “I have $50,000 and I would like to borrow $1,000,000 to build a stock porfolio.” The bank manager would politely show you the door. But if you walked into a bank with $50,000 to buy $1,000,000 in real estate, they may ask you if you are comfortable, and suggest starting the paperwork straight away.

With Canadian household indebtedness at record levels, Finance Minister Jim Flaherty announced sweeping changes to the mortgage rules, aimed at curbing household debt. In the July 2012 LePoidevin Letter, I stated that this would be “bad for housing.” Mortgage amortization periods would be lowered from 30 to 25 years. Mortgage insurance would only be available on houses valued at $1 Million or less, maximum loan size relative to income would be reduced, and home equity lines of credit (HELOC) would be lowered.



Ben Rabidoux Seminar – November 28, 2012 Canadian Real Estate: What Happens Next?

The latest figures from the Vancouver and Toronto Real Estate Boards confirm that such a downturn has begun. Vancouver sales are down 28.6% year-on-year (YOY); and prices are down 8.5%. Toronto sales are down 16%, but condo sales are down 25% YOY; while sales of detached homes fell a surprising 19% YOY. Both condos and houses saw average prices fall 4%. While some economists predict a soft landing (a soft decline in prices leading to no recession), it should be noted that Canada is still only four months into its new tighter lending practices. Governor of the Bank of Canada, Mark Carney, seems committed to staying the course. In fact, many of the new lending rules only took effect on November 1st, 2012. In any case, the brakes are firmly on now.



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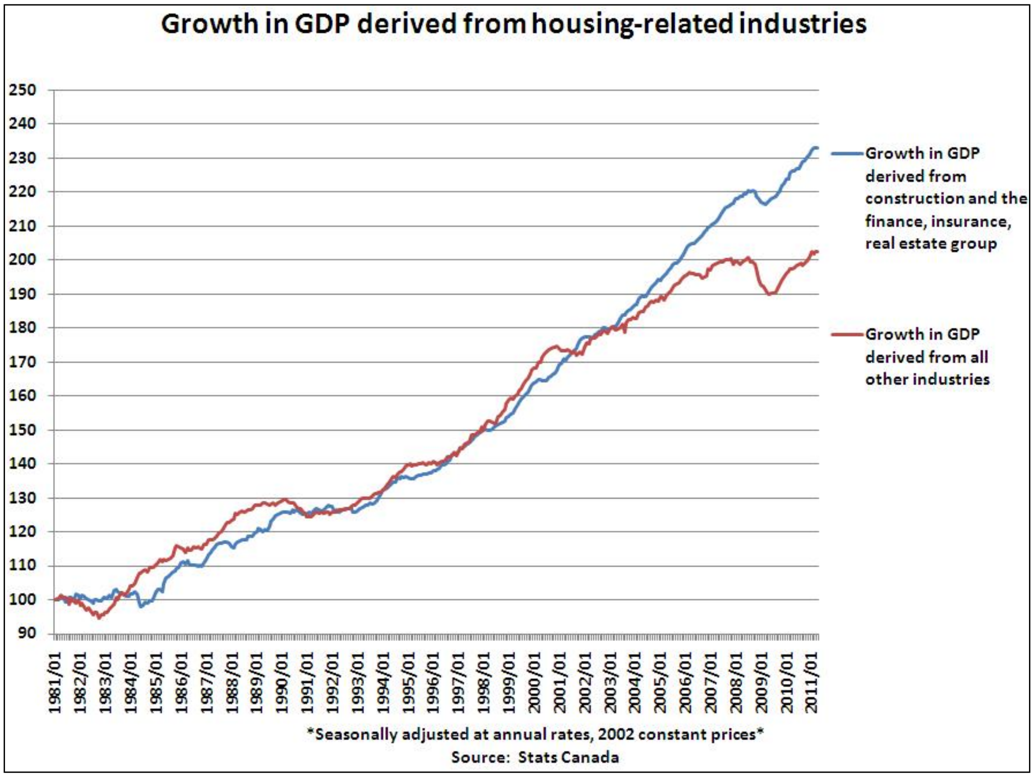
The major banks in Canada are in the business of lending money; and while banking has been a fantastic growth business for 30 years, all good things come to an end sooner or later. As U.S. bank stocks tanked in 2008, Canadian banks recovered and several went on to new highs as Canadians accelerated borrowing. Now that the lending brakes are on, however, this is unlikely to continue. Recent data shows a marked slowdown in consumer borrowing.[1]

While housing construction remained strong in 2012, housing resale activity slowed dramatically and brought lower prices; so builders may be hesitant to break ground on new construction in 2013. Recent U.S. GDP data shows an uptick to 2.7% growth in the 3rd quarter, while Canadian GDP lags badly at just 0.6%, on an annualized rate.

The following chart shows that housing has accounted for virtually all of Canada's GDP growth since 2008. As a consequence, the Canadian banks have become a larger and larger part of the TSX Index. The recent divergence between real estate prices, the lending cycle and stock prices may not continue. It should be noted that there are no banks among the 10 most valuable companies listed in the U.S. index, as measured by the S&P 500; whereas 5 of the 10 most valuable companies in Canada on the TSX Index are banks.

[1] Ben Rabidoux Seminar – November 28, 2012



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Top 10 positions as of Nov 30th, 2012

U.S. S&P 500	Canada TSX
1. Apple	**1. Royal Bank**
2. Exxon Mobil	**2. TD Bank**
3. Walmart	**3. Scotiabank**
4. General Electric	4. Suncor Energy
5. Google	5. CN Rail
6. Microsoft	**6. Bank of Montreal**
7. IBM	7. Barrick Gold
8. Berkshire Hathaway	8. Potash Corp of Saskatchewan
9. Chevron	9. BCE Inc
10. Johnson & Johnson	**10. Canadian Imperial Bank of Commerce**

I point this out because the U.S. credit cycle peaked six years ago and consequently U.S. banks have become far less important to both the U.S. economy and the U.S. stock market. Conversely, Canadian banks have never occupied so dominant a place in the Canadian economy or its stock markets as they do now, and this is right at the time when the brakes have been applied to their lending practices. The Canadian credit cycle has likely peaked; lending is slowing; and housing is in decline.

So far in 2012, the U.S. S&P 500 is up 12.81%, while the TSX is up only 2.30%. I have bet on U.S. companies in the past year and will continue to do so for 2013 and perhaps longer.

In conclusion: Economic cycle = lending cycle = housing cycle = bank stock cycle.

The safer place for investments at present may be in the U.S., where housing has already cycled down and has started to rise, rather than in Canada, where it has just begun to fall.

Sincerely,

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